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ABSTRACT

If taxes are higher in one town than in another it does not necessarily mean that residents of the low-tax town are better off; they may have had to pay high property prices to live in the more desirable low-tax town. It is incorrect to believe that property wealth differences are the only reason for spending disparities across towns. A more important cause appears to be income differences. Even if tax-prices were equalized across towns, wide differences in incomes would perpetuate differences in school spending. The Connecticut state tax reform program is tailored to lower the tax-price (or property tax rate) of education in income-poor towns. Under the present formula, state aid is in effect a lump-sum grant. Low-income towns may merely use this grant to support education and use the funds previously supporting the schools for other purposes, thus not increasing per pupil spending at all. What is really at issue with school finance reform is not differences in the price of education across towns but differences in incomes and the resulting abilities to pay. The total evidence here suggests that school finance reform now under way in Connecticut will not have the desired effect on per pupil spending. (Author/JM)

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SCHOOL FINANCE REFORM IN CONNECTICUT: PROPERTY VALUES AND SCHOOL SPENDING

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PREFACE

School Finance Reform is primarily a fiscal, political - and emotional - issue in Connecticut. Yet it is also an area of concern for serious students of real estate and land use, because its direct and immediate impact is, and will be, on the real property tax. In turn, the real property tax influences property values, land use decisions, and even decisions about where households or businesses will locate.

Considerable untested folklore and mythology exist about the market impact of real property taxes on property values and land uses. In particular, the capitalization of inter-town property tax differentials has received little real attention by objective scholars. Moreover, the view that ability (and willingness) to bear property taxes which support local education budgets is best measured by "wealth" in the form of taxable property values has been largely untested by serious research.

These and related questions have been addressed by Dr. William A. McEachern as Economic issues in CREUES Real Estate Research Report No. 22: School Tax Reform: The Equity and Efficiency Implications of Capitalization and Tax-Price Changes in Connecticut. The present volume is a popular, non-technical summary of that monograph. Readers interested in pursuing the topic in depth should consult that report.

The significant contribution of this summary and the research on which it is based lies in its objective economic analysis of a sometimes emotionally-charged problem that nevertheless requires rational resolution in Connecticut - and elsewhere. Dr. McEachern has put some long-standing shibboleths in serious question, and has raised some considerations heretofore overlooked in the earlier analysis and debate. His analytical conclusions are clearly supportable and useful; his policy recommendations and judgments are of course his own, and not necessarily those of the Center for Real Estate and Urban Economic Studies.

CREUES is pleased to have sponsored this important and useful work in an area of significant public policy. It is to be hoped that a more nearly rational and equitable program of financing public education in Connecticut will emerge, in part, because of this joint cooperative effort of sponsorship and study.

Storrs, Connecticut
December 1977

William N. Kinnard, Jr.
Director

CENTER FOR REAL ESTATE AND URBAN ECONOMIC STUDIES
SCHOOL OF BUSINESS ADMINISTRATION
THE UNIVERSITY OF CONNECTICUT
STORRS, CONNECTICUT

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December 1977

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CHAPTER 1

INTRODUCTION

Court cases challenging the constitutionality of current patterns of financing education have been argued in nearly 40 states and have gone to the United States Supreme Court. The basic problem, as viewed by the courts, is that a town's ability to finance education is not so much a function of the town's property tax rate, but of the town's property wealth. Wealthier towns, it is argued, are able to spend more on education using a lower tax rate than poorer towns. The courts have pointed out these discrepancies across towns and have asked state legislatures to adopt reforms to provide for greater equality in school financing.

The differences in revenue-raising ability across towns were dramatized in 1971 with the *Serrano* v. *Priest*[1] decision in California. Although the United States Supreme Court in *Rodriguez* v. *San Antonio*[2] ruled in 1973 that the United States Constitution does not describe education as a "fundamental right," the state courts have taken a closer look at their own statutes and constitutions. In view of the *Rodriguez* decision, *Serrano* v. *Priest* was once again tried in the California Supreme Court and found to be in violation of the California Constitution.[3] More than 19 states since *Rodriguez* have passed major school financing reforms and eight others have assumed a larger state share of funding.

Here in Connecticut, there have been two studies of educational finance sponsored by the State,[4] plus a third study funded by the Connecticut Education Association.[5] Each study has pointed to the wide disparity in

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[1]*Serrano* v. *Priest*, California Supreme Court 938254, L.A. 29820, 1971.

[2]*Rodriguez et al.* v. *San Antonio*, Independent School District et al. (1972) 377F. Supp. 280 (W.D. Tex.).

[3]"*Serrano* v. *Priest*," U. S. Law Week (January 25, 1977), pp. 2340-2341.

[4]Local Government: Schools and Property. (Hartford: The Governor's Commission on Tax Reform, II, State of Connecticut, December 1972); and Financing Connecticut Schools. (Hartford: Commission to Study School Finance, State of Connecticut, January 1975).

[5]The studies have been reviewed by the author elsewhere. See John J. Callahan, Jr., and William H. Wilken, Revision, Relief and Redistribution of the Connecticut State and Local Tax Structure. (Hartford: Connecticut Education Association, 1972).

the property base per pupil across Connecticut's towns and the consequent difference in each town's taxing ability. To correct for this disparity these studies have called for various degrees of State intervention, ranging from modestly revising the State student-aid formula, to a complete State take-over of local school financing, requiring massive infusion of new State revenues. Some plans simply call for dividing existing property tax revenues differently so that a portion of property taxes raised in the wealthier towns is transferred to the poorer towns.

The findings of earlier research, particularly the study entitled Financing Connecticut's Schools,[6] played a major role in the case of *Horton v. Meskill*[7] decided in Hartford County Superior Court in December of 1974. In his decision, Judge Jay Rubinow ruled that it is the State's constitutional duty to educate its children. This duty can be delegated to the towns only if this is deemed "appropriate." But, he argued, the current system is not appropriate. The State Supreme Court recently upheld this decision, noting that financing public schools largely from property taxes was unconstitutional because it denied equal educational opportunities to children from property-poor districts.[8] Largely in response to this, the State General Assembly, in the final hours of the 1977 session, approved a modestly-funded school finance reform measure designed to increase the revenue-raising ability of the low-property-base towns.

In spite of the voluminous literature concerning school finance reform, some aspects of the problem have been largely ignored. The author has examined several issues involving the equity and efficiency of proposed school finance reforms, and the results of this research raise questions concerning the basic fairness and likely effectiveness of these reforms. This research is reported in a much longer monograph published by the Center for Real Estate and Urban Economic Studies at the University of

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[6] Financing Connecticut's Schools.

[7] "*Horton v. Meskill*," Connecticut Law Journal (February 11, 1975), pp. 19-24.

[8] "*Horton v. Meskill*, Connecticut Supreme Court," The United States Law Week (May 3, 1977), pp. 2509-2510.

Connecticut.[9] The present paper represents an attempt to briefly summarize, in a non-technical way, the major findings reported in the larger study. Of necessity much documentation and supporting materials are deleted. Interested readers should consult the larger study for greater detail and the supporting statistical research.

The next chapter of this paper will discuss the extent to which cross-town differences in property taxes and public expenditures become capitalized into the value of property. The degree of this capitalization in Connecticut and its implications for the basic fairness of school finance reform will also be examined. The ultimate effectiveness of school finance reform in equalizing school spending across towns depends on how responsive local school spending is to changes in the share of school spending financed by the State. This issue will be considered in Chapter 3. Based on the findings in Chapter 2 and 3, some equity and efficiency implications of reform will be discussed in Chapter 4. Chapter 5 will briefly evaluate the State aid allocation formula in Connecticut, comparing it with the more traditional approach used around the country. The final chapter will briefly summarize the results and state the main conclusions.

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[9]William A. McEachern, School Finance Reform: The Equity and Efficiency Implications of Capitalization and Tax-Price Changes in Connecticut (Storrs: Center for Real Estate and Urban Economic Studies, University of Connecticut, Real Estate Report No. 22, 1977) 67 pp.

CHAPTER 2

CAPITALIZATION OF FISCAL DIFFERENCES ACROSS CONNECTICUT TOWNS

In spite of the voluminous literature in the area of educational finance reform, there is one topic that has received scant attention in the discussions. The effect of tax capitalization in the value of property has been all but neglected in previous studies even though this phenomena may have a heavy bearing on an equitable solution to the current dilemma.

A. Effects of Tax Capitalization

The effects of tax capitalization are best explained through a simple example.[10] Assume there are two towns that are quite similar except that Town A has a major industrial firm located within its borders, whereas Town B does not. As a result of the industry, Town A has a larger tax base per pupil and is, therefore, able to provide the same level of expenditures per pupil as Town B, but the total taxes paid on identical homes (considering construction and environment) will be lower in Town A. Assume that an individual is planning to move into the area and has narrowed his choice to identical homes in each town. Since the total taxes to be paid on the home in Town A are lower than the taxes in Town B (recall that the level of public services in each town are identical), then the individual will likely prefer to buy the home in Town A because the total bill he must pay (i.e., house payments plus taxes) is lower. Over time, individuals preferring houses (and house lots) in Town A will drive up the selling price of homes in that town relative to prices in Town B. Relative prices for housing will rise in Town A to the point where a homebuyer becomes indifferent between the house in Town A (with a higher selling price but lower taxes) and the house in Town B (with the lower selling price but higher taxes). At that point, the total stream of payments (house payments plus taxes) in each town will be equal.

The total cost of the house in Town A, at least theoretically, will eventually reach the total cost of an identical house in Town B. If the

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[10]This example is drawn from the author's earlier research. See McEachern, "Education Finance in Connecticut." pp. 63-64.

property tax rates in both towns are examined, town A will have a much lower tax rate than Town B. This results initially because of the presence of the major industry, but also because the effect of tax capitalization has driven up the sale price in Town A, thereby swelling the grand list in that town.

The point is that any fiscal advantage that residents in one town have over residents in another town will be negated through a higher price of homes in the more attractive town; in equilibrium there is no horizontal inequity across towns. A new resident will pay the same total price (sale price plus taxes) for a given quality of home regardless of whether the home is located in a high-tax or a low-tax town.

Of course, whether this capitalization phenomenon holds in the real world remains an empirical question. Evidence of capitalization is abundant. There have been more than a dozen recent studies examining the extent of property tax and public expenditure capitalization for various samples drawn from state and metropolitan areas around the country. Much of this research has been aimed at testing the hypothesis that consumers, in shopping for communities in which to live, will compete for homes in more attractive towns and, consequently, capitalize any fiscal advantages among towns. The usual approach involves explaining differences in median housing values across towns using, in addition to fiscal variables, a number of locational and structural factors. The objective is to isolate the marginal contribution of taxes and public expenditures to the value of housing. The results of this research appear to vary based on the geographical sample, with the most extensive capitalization occurring in metropolitan areas and the least capitalization taking place in more rural areas. Apparently, the supply of housing is more fixed in urban areas, so that fiscal differences become more fully capitalized in existing property.

B. Evidence of Capitalization in Connecticut

An examination of 54 urban and rural towns in Connecticut essentially confirms the extent of capitalization observed in other states and localities. Property tax differences are capitalized more extensively in urban than

in rural communities in Connecticut. The evidence concerning the impact of differences is school spending is less clear, but there is some evidence that greater school spending, other things equal, results in higher home values.

Empirical work on fiscal capitalization effects also sheds some light on the incidence of the property tax, in particular, whether landlords or renters ultimately pay the tax. For years the conventional wisdom has held that the property tax is a regressive tax. More recently some economists have argued that the property tax, when viewed as a tax on capital in a general equilibrium context, acts more like a profit tax and should therefore be more properly viewed as progressive. The evidence for Connecticut lends some support to the progressive thesis. Tax differences do not appear to be passed along to renters, but remain with the homeowner at the time of the tax change.

In spite of the evidence that taxing and spending differences across towns become capitalized in the value of property, the courts across the country have observed different "fiscal capacities" and have suggested a number of reforms, most involving the equalization of the effective tax base per pupil across towns. One result of such reform will be to appreciate the value of property in the aided towns and depress the value in the unaided towns. Hence, school finance reform will create winners and losers. Aside from these windfall capital gains and losses, the most important effect--and indeed of most interest to the courts--is the effect that school finance reform has on equalizing school spending across towns. Increasing the effective tax base in property poor towns has the effect of lowering the tax-price of education in those towns. The impact of this price change on school spending will turn on how sensitive the local demand for education is to changes in this tax-price of education. More directly, if the town can provide education more cheaply, how much more will it provide? This question will be addressed in the following chapter.

CHAPTER 3

THE DEMAND FOR EDUCATION IN CONNECTICUT

School finance reform has been predicted on the assumption that local school spending is sensitive to the local tax-price of education and decreases in that tax-price will result in substantially higher levels of spending. "Power equalization" programs represent attempts to alter the price of education so that the property-poor towns will be able to finance education as cheaply as property-rich towns. A variable with important policy implications for school finance reform is the price elasticity of demand for education spending.[11] How responsive is local school spending to changes in the price of education? Moreover, what portion of inter-town differences in school spending is attributable to differences in the price of education and what portion is due to other factors such as differences in income, or differences in the town's view of education?

The courts have implicitly viewed differences in the property base and the resulting differences in the tax-price of education as the primary sources of school spending differences across towns. Hence, in attempting to equalize the property base per pupil, the courts are groping for an equal tax-price of education. There are two problems with this. The first is that though the property base per pupil and the tax-price of education are related, they are not identical. Secondly, it may be that tax-price differences account for only a relatively small share of school spending differences. Both problems can be illustrated by examining the demand for education in Connecticut towns.

A household's demand for education is obviously the result of a number of forces. This study assumes that households attempt to maximize their utility subject to their budget constraints. Consistent with

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[11]The price elasticity of demand measures the percentage change in quantity demanded divided by the percentage change in price. For example, price elasticity with the value of one indicates that a 10 percent decrease in the price will result in a 10 percent increase in the quantity demanded.

orthodox demand theory, the household's demand for education is assumed to be a function of the tax-price of education, family income, and the family's attitude toward school spending.

Within a town, though, each family may desire different levels of education; only the outcome of the collective choice transmitted through the election of local officials is actually observable. In view of the collective nature of the choice of school spending levels, this study employed the majority-rule, median-voter assumption, which holds that the community's effective demand for education is that quantity demanded by the voter desiring the median amount of education. Simply put, this means that the outcome of collective choice, over time, generally reflects the views of the typical voter in the town.

The first step in a demand study is to establish what is the appropriate measure of good that is demanded; what is the quantity? In the absence of a more appropriate measure of quantity, local school spending per pupil represents the least ambiguous measure available. This measure captures aspects of both faculty quality and average class size. Since there is little variation in Connecticut in the outside aid component of school spending, this paper is concerned with only the local spending component.

A. The Tax-Price of Per Pupil Spending

If per pupil spending is viewed as the appropriate quantity measure for education, what will be the tax-price of education in a particular town? More specifically, what will it cost taxpayers to raise per pupil spending in the town by $1.00? The total cost will be this $1.00 increase multiplied by the number of students in the town, which is equal to n. Hence, the total cost is equal to n times $1.00 or simply $n. This represents the total cost to taxpayers, but what is the share borne by each taxpayer? Each taxpayer's share will depend upon his share of the total tax bill and this depends upon how much taxable property he owns relative to the total taxable grand list in the town. Thus, his fraction of total taxes will equal the assessed value of his property, AV, divided by the Taxable Grand List in the town, TGL.

$$\text{Taxpayer's share of tax bill} = \frac{AV}{TGL}$$

Therefore, the cost to a particular taxpayer of raising per pupil spending by $1.00 is the total increase in taxes, $n, times his share of the total, AV/TGL. This yields:

$$\text{Tax-Price Facing Individual Voter} = \$n \times \frac{AV}{TGL}$$

Within a given town, owners of higher-valued property will obviously pay a higher tax-price for education since their share of the total taxable base is greater. In this analysis the interest is in the behavior of the typical property owner and, accordingly, the focus is on the tax-price confronting the median homeowner in the town. Tax-prices for a $1.00 increase in per pupil spending faced by the median homeowners in Connecticut towns ranged from less than 30 cents to more than 80 cents.

Median family income for the town is the income measure employed. Again, median family income is assumed to be a reasonable approximation of the household income of the typical family in the town. The measure of the average family's preferences for education to be employed is the median education level of adults over 25 in the town. This is considered a reasonable estimate of the median voter's education level. While education and income can be expected to register some of the same effects (since education and income are likely to be strongly related), it is also likely that levels of education achieved in the median household will have an independent effect on the demand for education. Thus, the quantity demanded by the typical household in each town is a function of the median tax-price of education, the median family income, and the median level of education achieved by adults in the town.

A demand equation was estimated employing 133 of the State's 169 towns for which the above data could be collected. The year of observation was 1970. Of most importance is the price elasticity of demand (i.e., when other relevant factors are held equal, what appears to be the effect of a change in the tax-price of education on the per pupil spending). The statistical results yield a price elasticity of -0.30. This elasticity is rather low and indicates, for example, that if the tax-price of education is cut by 10 percent, per pupil spending will increase by only three percent;

or if the tax-price is cut by 50 percent, per pupil spending will increase by only 15 percent. In short, even if school finance reform results in dramatic changes in the share of school spending facing the average voter, this will not likely lead to equally dramatic increases in per pupil spending.

On the contrary, the income and the preference for education variables appear quite important in the school spending decision. If income in the town is increased by 10 percent, other factors held equal, then per pupil spending will increase anywhere from seven to 10 percent. Similarly, if the education of the adult population is somehow increased by 10 percent, other factors held equal, per pupil spending will increase by about 10 percent.

B. Matching Grant vs. General Aid

The derived price and income elasticities can now be employed to give us some idea of how effective alternative State funding policies will be in generating higher levels of per pupil spending. Assume that in a particular town facing a high tax-price for education, school spending is $1000 per pupil, with an average of one student per home. Assume the State now introduces a program designed to increase that town's effective tax base enough so as to cut the price facing the typical voter in half. This is essentially a matching grant with the State matching the locality dollar for dollar. With a price elasticity of -0.30, a 50 percent price reduction will result in a 15 percent increase in per pupil spending to $1150. This is hardly a dramatic rise in spending for such a drastic cut in the price. The State's share of the tax bill is $575 per pupil, and the local share is the same. Note that only a portion of State aid goes toward new school spending; the rest is absorbed either by other public outlays or by tax reductions.

If, rather than lowering the tax-price, the State simply awards this town a lump sum grant amounting to $575, what would be the impact of this aid on per pupil spending? If the median voter is permitted unrestricted substitutions in his spending (and there is some evidence that this in fact takes place), then he will view this lump sum grant as simply

an increase in his income, and the impact on school spending will depend upon the income elasticity of demand for education. In 1970 in Connecticut towns, school taxes for the median homeowner represented about three to four percent of median family income. This information, coupled with the fact that the income elasticity of demand for school spending is around 0.70, provides enough data to calculate the increase in school spending. If local governments receive on average $575 per pupil, then school spending will increase by (.04 x .70 x $575) about $15 or only about one-tenth the amount produced through price reductions.

But while tax-price changes are more effective than income changes, in neither case is the State grant program having much of an effect on the level of per pupil spending. The State could attempt to require that the aid be spent on education, but as long as the aid is less than the total amount the town would spend on its own, then the town will make substitutions in the budget. This is analogous to giving a family $5.00 a week and requiring them to spend it on groceries. If the grocery budget was already $25.00 a week, then the $5.00 will not likely lead to much of an increase in spending. The family will simply spend less of their own money on groceries. However, if the grant is $50.00 a week to be spent on groceries, then spending will obviously double. Of course, the family (and the town) would prefer having the money with no strings attached.

In view of these relatively modest spending increases resulting from outside aid, recent concern of teachers about the local use of State aid to education is not surprising. For example, the town of Waterbury is being sued primarily by teachers because town officials are using State aid-to-education funds to "balance the budget" rather than spending the money on education.[12] A similar case is in the courts in Bridgeport. The Governor, in view of the developments, predicts that more State influence will be employed in controlling how State aid is spent by localities.[13]

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[12]"Grasso Predicts More State Influence in Planning Local Schools." Hartford Courant (June 23, 1977) p. 20.

[13]Ibid.

Of course, school finance reform has now been in effect in a number of states around the country. Has this reform led to a narrowing of per pupil spending differences across school districts? According to William N. Wilkins of the National Conference of State Legislatures the effects of reform have fallen short of expectations: "[Reform] has not produced the dramatic narrowing of difference in school-district expenditures hoped for by many reformers."[14] As expected the effects of reform depend upon the nature of the reform.[15]

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[14]"Fiske, Edward B., "Tax Reform: Does It Balance Rich and Poor?" The New York Times, November 13, 1977, Section 12, p. 1.

[15]Ibid., pp. 1, 22.

CHAPTER 4

SOME EQUITY IMPLICATIONS OF SCHOOL FINANCE

Court decisions thus far have shown concern that a town's ability to finance education is not so much a function of the town's property tax rate, but the town's property wealth. Towns with greater property wealth per pupil are viewed as able to buy education for a lower "price." Implicit in judicial discussion is that towns with low property wealth are also poorer towns with respect to income. Therefore, it has been argued that poor people faced a higher price for education.

There have been few attempts to document the actual relationship between per pupil property wealth and family income across towns. Studies of school districts in California, Washington, and Texas have found no clear relationship between per pupil wealth and median family income in the town.[16] This lack of a clear relationship results partly from the fact that older urban areas still retain the commercial and industrial tax base that initially led to higher per pupil wealth, but many higher income residents have long since moved to the suburbs. Moreover, central cities tend to have a smaller ratio of students to the total population and this results in greater property wealth per pupil. For the sample of 133 Connecticut towns used in this study, the relationship between property wealth per pupil and median family income is positive, but relatively weak.

A. Tax-price and Income

Perhaps of more relevance in judicial thinking is the relationship between family income and the tax-price of education paid by the median

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[16]M. Cox, "Equality in Educational Finance: An Analysis of the Distribution of Taxes and Educational Benefits by Districts." Ph.D. dissertation, University of Southern California, 1975; W. R. Anderson, "School Finance in Washington: The Northshore Litigation and Beyond." Washington Law Review, 50 (1976), pp. 853-900; and *Rodriguez et al. v. San Antonio*, Independent School District et al. (1972), 377 F. Supp. 280 (W. D. Tex.).

voter derived earlier. Although such a relationship has not been examined elsewhere, the conventional wisdom suggests that towns with low-median, family incomes face, on the average, higher tax-prices. But an examination of our sample indicates just the opposite: there is a positive and statistically significant relationship between the tax-price faced by the median homeowner in the town and the median family income in the town. It is, therefore, the higher income towns that tend to face the higher prices for education. And reforms designed to lower the price of education in high-price towns would result in more aid to high-income towns.

The reasons for the positive relationship between the tax-price and median family income relate to the fact that higher-income towns in the State tend to have a higher ratio of students as a percentage of the population. With more students, the cost of raising per pupil spending in the town increases. On the contrary, Connecticut's central cities have lower ratios of students to the population and, consequently, face lower tax-prices, but these same cities also have lower median family incomes. It is also likely that high-income towns tend to be more exclusive and rule out much of the industrial and commercial property existing in other towns.

Not only is the tax-price of education higher in high-income towns, school taxes paid as a percentage of income also tends to be higher. Thus, the residential portion of school taxes is progressive across towns (though it should be remembered that high-income towns tend to provide higher per pupil spending).

B. The Distribution of Incomes and Housing Values Within and Across Towns

Another assumption implicit in judicial analysis is that all residents of a jurisdiction are members of a "suspect class" because of a lower property base and the presumed higher price for education. But, of course, towns are not uniformly poor or rich, nor do towns have uniformly low-priced homes or uniformly high-priced homes. Research into the distribution of incomes and housing values within and across Connecticut towns uncovers some interesting patterns. First, with respect to income, there is no apparent relationship between the average income in the town and either the distribution of incomes or the distribution of housing values in that town. High-income towns tend to be as widely diverse with respect to incomes and housing values as low-income towns.

While there is no particular relationship between the average level of income in the town and income or housing homogeniety in the town, it is true that towns that are more homogeneous with respect to income are also more homogeneous with respect to housing values. More simply stated, towns with families having a wide distribution of incomes also have a wide distribution of housing values.

There is a clear relationship between the price of education and both income and housing homogeneity. Towns facing higher tax-prices for education tend to be more homogeneous with respect to both income and housing values. Hence, if the objective of school finance reform is to aid the high tax-price towns, then residents of the aided towns tend to be more homogeneous than residents of the unaided towns. Because property values in aided towns are more homogeneous, then homeowners within a given aided town will experience similar growth in property values.

It is also true for Connecticut that towns with a low property base per pupil are more homogeneous with respect to incomes and property values. Thus, if school finance reform is designed to help towns with a low property base per pupil, homeowners in each town will experience a similar growth in property values. Conversely, those towns receiving no State aid--the towns with a high property base per pupil--will have a more widely divergent mix of incomes and housing values. Hence, the losers in school reform will be a more mixed lot than the winners.

CHAPTER 5

THE 1977 SCHOOL FINANCE REFORM IN CONNECTICUT

In response to the State Supreme Court's decision in *Horton v. Meskill* the General Assembly in the closing minutes of the 1977 session passed a modestly funded school finance reform bill.[17] The reform measure, though a result of compromise, is weighted heavily toward aiding the central cities. The bill is designed to raise, over time, the revenue-raising ability of all towns to the level achieved by the 85th percentile of all towns. The present funding level of 20 million dollars covers less than 10 percent of what it would cost to do this. In this chapter, the allocation formula will be briefly reviewed; it will be compared, in particular, to the more traditional power-equalization formula. Then, the likely impact of the bill in terms of changes in school spending and in property values will be discussed.

The measure of taxing liability employed is the town's taxable base per capita adjusted for differences in income across towns. The grant that a town below the 85th percentile receives depends on three components: (1) the school tax rate employed in the town two years prior to the year in question; (2) the difference between the taxing ability (effective per capita taxable base adjusted for income) for the town in the 85th percentile and for the town in question; and (3) a person count by which the first two components are multiplied to yield the total grant to the town. This person count consists of the number of students in the town two years prior to the year in question, plus one-half of the town's population as of 1970, plus one-half of the number receiving aid to dependent children two years prior to the year in question. In short, the aid received by a town below the 85th percentile can be found by multiplying the school tax rate times the difference in the effective tax base between the town in the 85th percentile and the town in question times the person count.

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[17]"An Act Establishing a Guaranteed Tax Base Program to Finance Public Elementary and Secondary Education." State of Connecticut, House of Representatives, 1977, Public Act 77-540. Actually, there were several bills concerning funding, reassessment procedures, and the formula itself. For a more complete description of the allocation formula see "Guaranteed Tax Base Grant--Town Data: 1977-78." (Hartford: Department of Education [Division of Administrative Services, Bureau of Research, Planning and Evaluation] State of Connecticut, 1977).

A. The School Tax Lag

Because there is a two-year lag in the school tax rate employed in the formula, State aid received by the town in a given year will be unrelated to the current choice of school tax rates. What may happen is that State aid will be viewed more as a lump sum grant than a matching grant designed to change the tax-price of education. Since the grant received this year has nothing to do with the currently chosen level of tax effort, then taxes are more likely to be set with the views that State aid is beyond the control of the locality. If State aid is simply viewed by the town as a lump sum grant, there will be some increase in spending due to the increase in income, but none due to a change in the tax-price of education. Recall that the lump sum grant was much less effective in stimulating additional school spending than matching grants designed to change the tax-price of education.

Of course, if the allocation formula becomes firmly set and appears likely to continue for years, then, over time, voters should come to realize that the tax rate selected this year will affect the school aid received two years hence: the higher the tax rate selected, the more aid in two years. Under these circumstances the tax-price effect may eventually take hold (i.e., voters will realize that education is actually cheaper). Recent events, however, tend to underscore the tentative nature of current legislation. The Connecticut School Finance Advisory Panel has been formed to make recommendations to the General Assembly concerning the extent and nature of school finance reform. Few believe that the formula adopted in the compromise bill will remain in force for long. To repeat, the more temporary the bill appears to be, the more likely the aid program will be viewed as simply a lump sum grant rather than a matching grant; consequently, the less likely this aid will stimulate school spending.

B. Connecticut Formula vs. Traditional Approach

A more traditional allocation formula is simply to multiply the school tax rate times differences in the taxable base per pupil times the number

of pupils. The two formulas considering alternative aid objectives can be compared. Assume that the objective of school finance reform is to lower the tax-price of education in those towns confronting high tax-prices. In comparing the Connecticut formula with the traditional approach, in no respect does the State formula improve the link directing school aid to towns facing higher tax-prices. In fact, each change only weakens this relationship: property wealth per capita is less related to the tax-price than is property wealth per pupil; adjusting for income also diverts aid from the high tax-price towns; population and the measure of poverty are inversely related to price; and although the number of students remains in the person count, its effects are diluted by the addition of the population and poverty measures.

If, rather than lowering the tax-price for high-price towns, the objective is to lower the tax-price for low-income towns, the State formula is superior to the traditional formula. There is a stronger link between property wealth per capita and median family income than between property wealth per pupil and median family income. And, of course, adjusting for income differences also favors poorer towns. More populated towns and towns with a larger percentage of poor also tend to be poorer with respect to median family income. Thus, including these elements in the person count favors poorer towns. Moreover, towns with a higher student content in the population tend to have higher median incomes, so diluting students in the person count by population and by poverty figures direct more funds toward low-income towns.

C. Capitalization Effects of Reform

At present, school finance reform in Connecticut is in the state of flux, and because of this uncertainty it is less likely that the particular formula now in effect will result in immediate and complete fiscal capitalization. But if it is assumed that the present aid formula is adopted as a long-term reform, that the population believes it will continue indefinitely, and that it is adequately funded, what capitalization effects are likely to occur?

In general, property owners in towns receiving aid will benefit; those in other towns will not benefit and may even suffer capital losses. The distributions of benefits and losses within towns will depend upon both the distribution of home values and how State aid is used. The State aid formula recently adopted tends to help lower-income towns. There is no particular relationship between median family income and the distribution of property values within the town. Low-income towns appear to have about the same degree of homogeneity (or heterogeneity) as high-income towns. Thus, in poorer towns there is a distribution of winners and in richer towns a similar distribution of losers. No doubt, across towns there will be individuals with comparable incomes who will reap capital gains in the poor towns and perhaps suffer capital losses in the rich towns. Thus, there will likely be some horizontal inequity.

Based on a theoretical model developed in the larger study,[18] it was concluded that the greater the increase in school spending resulting from school aid to the town, the greater will be the benefit received by owners of the lower-valued homes. On the contrary, the more that State aid simply turns into lower taxes, the more likely will capital gains, as a percentage of the value of homes, be proportional across properties. This is due to the fact that the benefits received from an increase in school spending in a town are not proportional to the value of a homeowner's property, but the benefits received from a general property tax reduction are linked to the value of the property. Based on the current State formula and based on the relatively low price elasticity of demand derived earlier, it appears unlikely that much of the school aid will find its way into higher per pupil spending. Most of the aid will be used to relieve the property tax burden, and perhaps finance other public goods. With little aid going toward increased school spending, property appreciation will tend to be proportional across homeowners.

If State aid does not go to towns with higher median family incomes, property values in these towns are likely to decline or at least not appreciate as quickly. The demand for property in these towns will decline for

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[18]McEachern, A School Finance Reform.

two reasons: first, with less State aid over time, local taxes will likely rise; and second, other towns will become more fiscally attractive as a result of reform. These towns will likely receive less State aid than they otherwise would, resulting in a greater local tax effort and possibly less school spending. The higher taxes and lower spending will become capitalized into the value of homes and result in lower property values. If other towns become more fiscally attractive after reform, the demand for property in the higher-income towns may decrease, leading to lower property values.

D. Impact on Renters

The poorest members of any town will often be renters. Based on census data less than 10 percent of the minorities living in Connecticut's central cities live in their own home.[19] There is little in the reform package that will be attractive to them. Since they own no property, they will not experience the windfall gains in property values resulting from more State aid. Moreover, because of the low price elasticity of demand for education, State aid will likely result in little increase in per pupil spending. Indeed, there is evidence that even if spending goes up as a result of State aid, the renter could wind up paying for it through higher rents. Moreover, if the aid program is financed through a regressive tax, these renters would probably be worse off after the reform. In any event, it is the owners of these rental properties who will be the primary beneficiaries of reform, and if these owners are higher-income residents, then windfall gains will most benefit higher-income families.

[19]U.S. Department of Commerce, Bureau of the Census, 1970 Census of Population, (Washington, D.C.: U.S. Government Printing Office, 1972).

CHAPTER 6

SUMMARY AND CONCLUDING REMARKS

In a world in which tax and expenditure differences across towns are at least partly capitalized into the value of property, there is little horizontal inequity. Any fiscal advantage possessed by homes in one town tends to be negated through higher prices, and homebuyers at the margin will become indifferent between otherwise identical homes. In view of capitalization, comparisons of tax burdens across towns lose some of their normative significance. To say that taxes are higher in one town than in another does not necessarily mean that residents of the low-tax towns are better off; perhaps original property owners in the low-tax town received windfall capital gains, but, over time, new entrants have paid for their lower taxes through higher property prices.

The courts have observed fiscal differences across towns and have called for equalizing the revenue-raising power across towns. This approach has been true in Connecticut as well. In the recent Connecticut Supreme Court decision of *Horton v. Meskill*, the Court argued that

> The wide disparities that exist in the amount spent on education by the various towns results primarily from the wide disparities that exist in the taxable wealth of the various towns...[M]ore educational dollars will be allotted to children in property rich towns.[20]

Although the Court did not make specific recommendations, equalizing the effective property tax base has been viewed favorably as a means of ensuring greater equality in education.

This study indicates that greater property wealth per pupil results in a lower tax-price for education, and this lower tax-price in turn leads to some increase in pupil spending. To credit property base differences and the underlying tax-price differences as the primary source of spending disparities across towns is simply incorrect. The evidence suggests that income differences across towns are more important than tax-price differences. For example, if the median homeowner in one town faces a price for education

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[20] *Horton v. Meskill*, p. 2510.

that is only half that faced by the median homeowner in another town, the low-price town will spend only about 15 percent more on education, other factors equal. However, if family income in a town is, on average, double that of another town, then the high-income town will spend from 70 to 100 percent more on education. Hence, even if tax-prices were equalized across towns, wide differences in incomes would remain and these would perpetuate differences in school spending.

The State reform program is tailored more to lower the tax-price of education for income-poor towns than high tax-price towns. Indeed, central cities in the State's five Standard Metropolitan Statistical Areas all have tax prices for education that are below the State average, but these cities rank low in terms of income. Under the present reform formula, it seems doubtful that State aid will be viewed as a price-changing mechanism at all, but will rather be regarded simply as a lump sum grant which can be used to finance education, to finance other public services, or to lower taxes. Therefore, the public should not expect dramatic rises in school spending to result from the recent reform, even when funded at a more adequate level. Although the reform measure is billed as a school finance reform package, it is more a vehicle to channel more State funds to poor towns, particularly the central cities. While this effort may be worthwhile, it should not be called school finance reform.

What is really at issue with school finance reform is not so much differences in the price of education across towns; indeed as this study indicates, the price is higher in high-income towns. The issue is not the incidence of school taxes across towns, for families in high-income towns tend to pay a higher fraction of their income for education. Moreover, any fiscal advantage that one town has over other towns should be reflected in the value of property across towns. What is at issue is how to provide for equal opportunity of education, when incomes and resulting abilities to pay differ so dramatically across towns. Finally, in terms of equity, how can policymakers address the fact that each town is not a homogeneous group, but a distribution of families with different incomes and different tax-prices?

One option open is full State funding at some specified levels for each town. This would equalize school spending, but it would also bypass local choice in determining the level of spending, and, of course, it would restrict individual choice in choosing a town based on the bundle of taxes and spending. This would set off a whole chain of capitalization effects.

As is often the case, this research raised more issues than it answered. School finance reform is not a simple issue, and it should not be viewed simply as a process of taking money from the rich and turning it over to the poor. The present school reform bill in Connecticut should not be viewed so much as a school finance bill, but as a vehicle for delivering more State funds to the majority of Connecticut towns, in particular, the central cities. These towns are populated by both high- and low-income individuals alike. In fact, the central cities have a wider distribution of incomes than do other towns in the State. The evidence here suggests that it is the higher-income households in those towns who will be the primary beneficiaries of reform. One might ask why certain high-income individuals should benefit at all when households of similar incomes in other towns do not.

Perhaps more important than capitalization considerations is the education of the children in these poorer towns. The evidence here suggests that school finance reform now under way in Connecticut will not have the desired effect on per pupil spending, even if funded more adequately.

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